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SECTION 202 OF THE DELAWARE CORPORATION LAW —PER SE RULES FOR STOCK TRANSFER RESTRICTIONS

The identity of the shareholder is of concern to many corporations, particularly close corporations. These corporations are small companies that have incorporated in order to obtain limited liability and other advantages of the corporate form, but which are managed as if they were sole proprietorships or partnerships.¹ The shareholders take an active part in management and, of necessity, must work closely with each other.² Also, profits may be distributed in the form of salaries which reflect services rendered the corporation, and are not subject to double taxation as are dividends.³ An outsider who desires to become a part owner in these corporations may create a number of problems. The corporate organization may require that the stockholder take an active part in management, but the other active shareholders will desire the opportunity to select the individuals with whom they must work in managing the corporation.⁴ If, on the other hand, the securities are purchased for investment, there will be a conflict with the practice of shareholder participation in management and of the distribution of profits as salaries rather than as dividends. Finally, if, in either case, the sale will increase the number of shareholders, there may be a conflict with the corporation's desire to limit that number since the number of shareholders may be determinative of whether the corporation is a "close corporation" entitled to special privileges under the applicable corporation⁵ or tax laws.⁶

Although the selection of shareholders is primarily the concern of close corporations, other types of corporations may, because of the particular nature of their business, desire this control. The members of a cooperative apartment building will desire to have some control over the selection of those who will become tenants by purchasing the organization's shares.⁷ A corporation supplying local services may wish to keep ownership within the community.⁸ Similarly, a corporation may use employee ownership to attract personnel or to create an interest among the employees in the corporation and, therefore,

¹ F. O'Neal & J. Derwin, *Expulsion or Oppression of Business Associates* § 2.10, at 23 (1961).

² See *Casper v. Kalt-Zimmers Mfg. Co.*, 159 Wis. 517, 522, 149 N.W. 754, 756 (1914); O'Neal, *Restrictions on Transfer of Stock in Closely Held Corporations: Planning and Drafting*, 65 Harv. L. Rev. 773 (1952).

³ F. O'Neal & J. Derwin, *supra* note 1, § 2.03, at 13.

⁴ The right of shareholders to select their associates has long been established. See *Barrett v. King*, 181 Mass. 476, 479, 63 N.E. 934, 935 (1902).

⁵ See Del. Code Ann. tit. 8, § 342(a)(1) (*Corporation Trust Co., General Corporation Law of Delaware* (1967)) [hereinafter cited as *Del. Corp. Law*] (thirty shareholders).

⁶ See Int. Rev. Code of 1954, § 1371(a)(1) (ten shareholders). Stock transfer restrictions may also be used to exempt the corporation from the registration requirements of the Securities Acts of 1933. Since registration is a costly and time consuming procedure, many corporations use stock transfer restrictions to obtain an exemption. See 1 L. Loss, *Securities Regulation* 665-73 (2d ed. 1961).

⁷ See *Penthouse Properties, Inc. v. 1158 Fifth Ave., Inc.*, 256 App. Div. 685, 691, 11 N.Y.S.2d 417, 422 (1939).

⁸ See *Wright v. Iredell Tel. Co.*, 182 N.C. 308, 108 S.E. 744 (1921).

wish to limit ownership to those who are employed by the corporation.⁹ In each type of corporation mentioned, the ability to select security holders will also give the corporation a means of preventing competitors from purchasing shares in order to participate in the policy decisions of the corporation¹⁰ or in order to look at the corporate books and records.¹¹

As the examples given above indicate, there are a number of personal and business purposes that may be served by being selective in choosing stockholders. This selectivity has been achieved most efficiently through the use of stock transfer restrictions. Strictly speaking these restrictions are conditions imposed on the right of the stockholder to alienate his interest in the securities. As used today, however, the phrase "stock transfer restrictions" encompasses any condition or privilege accompanying the right to freely transfer or retain ownership in stock.

The most popular restriction is the "first-option,"¹² which requires the holder of the stock to give a named person, usually the corporation, an opportunity to purchase the stock before it can be transferred to a third party. The optionee can permit the transfer if he finds the proposed transferee acceptable. If not, the optionee can purchase the stock and hold it or sell it to an individual of his own choosing.

The second major type of restriction is the consent restriction. This restriction requires the holder of the stock to obtain the consent of some individual or individuals, such as the board of directors, before a transfer of the stock can be made. Although the person who must consent does not have the right to buy the stock as he does when a first-option restriction exists, he can obtain virtually the same control by choosing an acceptable transferee and refusing to consent to a transfer to anyone else. In fact, the consent restriction is often a better method of protection since exercise of the consent restriction does not require an initial outlay of capital to channel the stock into the hands of an acceptable holder.

The third major type of restriction is a buy-out agreement. This restriction imposes an obligation on the corporation or the shareholders to purchase the stock, and on the holder to sell the stock, upon the occurrence of a named contingency, such as the death of the shareholder or his retirement from the employment of the corporation. The bilateral obligations imposed by the restriction provide some protection to both the corporation and the holder of the stock. The purchase gives the corporation the same opportunity to select new shareholders that it enjoys with the first-option restriction, but this restriction is broader in its application since it operates on more contingencies than just the holder's attempt to transfer the shares.¹³ The shareholder, on the other hand, is provided with a market for his stock which, if the corporation is small, he might not otherwise be able to find.¹⁴

⁹ See *Martin v. Graybar Elec. Co.*, 285 F.2d 619, 621 (7th Cir. 1961).

¹⁰ See *Mason v. Mallard Tel. Co.*, 213 Iowa 1076, 1087, 240 N.W. 671, 675 (1932).

¹¹ See *Model Clothing House v. Dickinson*, 146 Minn. 367, 372, 178 N.W. 957, 959 (1920).

¹² Cataldo, *Stock Transfer Restrictions and the Closed Corporation*, 37 Va. L. Rev. 229, 233 (1951).

¹³ See *W.O. Barnes Co. v. Folsinski*, 337 Mich. 370, 377, 60 N.W.2d 302, 306 (1953).

¹⁴ O'Neal, *supra* note 2, at 796.

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A full buy-out restriction is unnecessary, however, when both parties do not require protection. If, for example, the shares are not readily marketable and the corporation does not care who holds them, it is not necessary that there be a requirement on the stockholder to sell, although the stockholder may still need the protection of being able to require the corporation to purchase.¹⁵ On the other hand, if the shares are readily marketable, but the corporation desires that all stockholders take an active part in the corporation, only a requirement that a retiring stockholder offer the stock to the corporation is necessary.¹⁶

Despite the extensive use of these stock transfer restrictions to achieve corporate purposes,¹⁷ the courts have not always been willing to find them valid. The English courts have held that stock represents a contractual relationship between the stockholder and the corporation.¹⁸ As a result, these courts permit almost all restrictions as valid terms of that contract.¹⁹ American courts, on the other hand, have treated stock not only as evidence of a contract but also as personal property.²⁰ As a result, transfer restrictions may conflict with the common law principle that any attempt to restrain the transfer of personal property is contrary to public policy.²¹

Initially the American courts viewed any restriction as a violation of public policy,²² but gradually the courts began to realize the need for restrictions in some corporations and that this need should be balanced against the policy favoring free alienability.²³ In evaluating the corporate need, the courts took into account the size of the corporation,²⁴ its objectives,²⁵ its ownership distribution,²⁶ and the possibility that hostile shareholders would seriously injure it.²⁷ Then the courts focused on the restriction itself, looking at the degree of restraint,²⁸ its duration,²⁹ and the possibility that the type of restriction im-

¹⁵ G. Hornstein, *Corporation Law and Practice* § 195, at 258 (1959).

¹⁶ See *Martin v. Graybar Elec. Co.*, 285 F.2d 619 (7th Cir. 1961).

¹⁷ A study in 1952 showed that nearly 50% of the corporations formed in Iowa in a six-month period included stock transfer restriction provisions in their charters. It is not known how many more provisions were placed in the by-laws or originated by stockholder agreement. *Hayes, Corporation Cake With Partnership Frosting*, 40 Iowa L. Rev. 157, 159, 181 (1954).

¹⁸ *Grower, Some Contrasts Between British and American Corporation Law*, 69 Harv. L. Rev. 1369, 1377 (1956).

¹⁹ *Id.*

²⁰ F. Christy, *The Transfer of Stock* § 36, at 5:1 (4th ed. 1967). Many corporation statutes provide that shares of stock are personal property. See, e.g., Del. Corp. Law § 159.

²¹ *Painter, Stock Transfer Restrictions: Continuing Uncertainties and a Legislative Proposal*, 6 Vill. L. Rev. 48, 49 (1960).

²² See, e.g., *Victor G. Bloede Co. v. Bloede*, 84 Md. 129, 141-42, 34 A. 1127, 1129 (1896).

²³ See, e.g., *Tracey v. Franklin*, 31 Del. Ch. 477, 67 A.2d 56 (Sup. Ct. 1949); *Lawson v. Household Fin. Corp.*, 17 Del. Ch. 343, 152 A. 723 (Sup. Ct. 1930).

²⁴ See *People ex rel. Rudaitis v. Galskis*, 233 Ill. App. 414, 420 (Ct. App. 1924).

²⁵ See *Lawson v. Household Fin. Corp.*, 17 Del. Ch. 343, 152 A. 723 (Sup. Ct. 1930).

²⁶ See *First Nat'l Bank v. Shanks*, 34 Ohio Op. 359, 73 N.E.2d 93 (C.P. 1945).

²⁷ See *People ex rel. Rudaitis v. Galskis*, 233 Ill. App. 414, 420 (Ct. App. 1924).

²⁸ See *First Nat'l Bank v. Shanks*, 34 Ohio Op. 359, 360, 73 N.E.2d 93, 94 (C.P. 1945).

²⁹ See *Tracey v. Franklin*, 31 Del. Ch. 477, 484, 67 A.2d 56, 59-60 (Sup. Ct. 1949).

posed would serve the needs of the corporation.³⁰ The ultimate question to be answered was "whether the restraint is sufficiently needed by the particular enterprise to justify overriding the general policy against restraints on alienation."³¹ Increasingly, modern courts have been willing to strike this balance in favor of the corporation, and uphold restrictions that older courts had found to be unreasonable.³²

The application of the modern balancing test is a compromise between the policy against restraints on alienation and the legitimate business purposes to be achieved. It has, however, created a great deal of uncertainty in the law.³³ There are a few categories of restrictions: first-option, consent, and buy-out. Similarly, there are a few categories of corporations that use stock transfer restrictions, such as close corporations, employee owned corporations, and cooperative buildings. Yet in many jurisdictions there are no decisions indicating whether the major types of corporations have a valid need for restrictions, nor are there decisions considering the validity of one or more of the major types of restrictions.³⁴ Even if there were authority on each of the types of restrictions, there would still be uncertainty as to the validity of some terms, such as option price or time in which consent must be given.³⁵ Also, even within a particular type of corporation, each one is different in terms of size, ownership distribution and objectives. Finally, existing case law is frequently old and does not reflect the more permissive attitude of modern courts.³⁶ These uncertainties severely limit the ability of a corporation, in assessing the alternative methods of control, to know, at a minimum, the validity of the various types of stock transfer restrictions.

A number of states have enacted statutes to establish legislative authority for stock transfer restrictions.³⁷ The majority of these statutes do no more than provide that restrictions may be placed in the by-laws or charter. While recognizing the need for restrictions, they do not deal with the uncertainties generated by the balancing test.

Recent state legislation, however, has attempted to provide some stability and certainty in the area. The Texas Business Corporation Act³⁸ allows the use of reasonable restrictions including "reasonably" imposed first-option

³⁰ See *Greene v. E.H. Rollins & Sons, Inc.*, 22 Del. Ch. 394, 400, 2 A.2d 249, 252 (1938).

³¹ O'Neal, *supra* note 2, at 779.

³² Childs, *Control of Transfer of Business Interests*, 1958 U. Ill. L.F. 79, 83.

³³ Painter, *supra* note 21, at 62.

³⁴ See, e.g., Barron, *Arrangements—Validity and Enforcement of Restrictions on Share Transfer and Buy-Out Various Types of Restrictions in Ohio*, 31 U. Cin. L. Rev. 266, 268-69 (1962), where the author recommends that consent restrictions should not be used in Ohio since no Ohio cases have held them valid.

³⁵ See *In re West Waterway Lumber Co.*, 59 Wash. 2d 310, 317, 367 P.2d 807, 811 (1962).

³⁶ O'Neal, *supra* note 2, at 780.

³⁷ See, e.g., Cal. Corp. Code § 501(g) (West 1955); Fla. Stat. Ann. § 608.0105(1)(d) (Supp. 1966). New Hampshire has a provision allowing for restrictions in the charter, N.H. Rev. Stat. Ann. § 294:29 (1966), but also has a section that states that any by-law imposing a restriction is void. Id. § 296:14.

³⁸ Tex. Bus. Corp. Act art. 2.22 (1956), as amended, (Supp. 1966). See also Ark. Stat. Ann. § 64-211 (1966).

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and buy-sell restrictions. While the requirement that the restriction be reasonable restates the common law, the fact that the legislature has specifically enumerated these particular restrictions at least shows the courts that these restrictions are not per se invalid. The Wyoming legislature has taken a similar approach, although it has expanded the coverage of its statute to include consent restrictions.³⁹

The recently enacted Delaware Corporation Law⁴⁰ contains a section on stock transfer restrictions similar to that enacted in Wyoming. Certain enumerated restrictions are permitted under section 202: a first option, a purchase obligation, a consent requirement, and a restriction providing that the holder may not transfer to certain persons or classes of persons.⁴¹ These restrictions, and any other lawful restrictions, may be enforced against the holder of the securities or his successor or transferee.⁴² The statute also provides that restrictions used to maintain Subchapter S status under the Internal Revenue Code are conclusively presumed to be for a reasonable purpose.⁴³ Under section 202, permitted stock transfer restrictions may be placed in the articles of incorporation, by-laws, or in a contract, but the holders of shares issued before the restriction was imposed must consent to the restriction before their shares will be bound.⁴⁴ The restriction is ineffective, however, ex-

³⁹ Wyo. Stat. Ann. § 17-36.32 (1965). See Rudolph, *The New Wyoming Business Corporation Act*, 15 Wyo. L.J. 185, 195 (1961).

⁴⁰ Del. Corp. Law § 202.

⁴¹ (c) A restriction on the transfer of securities of a corporation is permitted by this section if it:

(1) Obligates the holder of the restricted securities to offer to the corporation or to any other holders of securities of the corporation or to any other person or to any combination of the foregoing, a prior opportunity, to be exercised within a reasonable time, to acquire the restricted securities; or

(2) Obligates the corporation or any holder of securities of the corporation or any other person or any combination of the foregoing, to purchase the securities which are the subject of an agreement respecting the purchase and sale of the restricted securities; or

(3) Requires the directors or the holders of any class of securities of the corporation to consent to any proposed transfer of the restricted securities or to approve the proposed transferee of the restricted securities; or

(4) Prohibits the transfer of the restricted securities to designated persons or classes of persons, and such designation is not manifestly unreasonable.

Id. § 202(c).

⁴² (a) A written restriction on the transfer or registration of transfer of a security of a corporation, if permitted by this section and noted conspicuously on the security, may be enforced against the holder of the restricted security or any successor or transferee of the holder including an executor, administrator, trustee, guardian or other fiduciary entrusted with like responsibility for the person or estate of the holder. . . .

Id. § 202(a).

⁴³ *Id.* § 202(d).

Subchapter S permits certain close corporations to elect special tax status. A corporation that elects this tax status is not subject to an income tax. Instead, its income and losses are considered the income and losses of the shareholders. Int. Rev. Code of 1954, §§ 1371-77. See 1 F. O'Neal, *Close Corporations* § 2.04a (Supp. 1967).

⁴⁴ (b) A restriction on the transfer or registration of transfer of securities of a corporation may be imposed either by the certificate of incorporation or by the by-laws or by an agreement among any number of security holders or among

cept against a person with actual knowledge of it, or unless the restriction is noted conspicuously on the security.⁴⁵

The Delaware statute is important for a number of reasons. First, many businesses are incorporated in Delaware,⁴⁶ so that a corporation statute of this state will have a widespread effect.⁴⁷ Second, in Delaware, all of the issued stock of all classes must be subject to one or more of the restrictions on transfer permitted by section 202 to qualify for special privileges as a close corporation.⁴⁸ Finally, because of the uncertainties prevalent in the case law, and the widespread use of stock transfer restrictions, if legislation such as the Delaware statute injects the desired certainty without substantially impairing the right of free alienation, this statute would serve as an excellent model for future state legislation in this area.

This comment will attempt to analyze Section 202 of the Delaware Corporation Law to ascertain the extent and manner in which it modifies the common law relating to stock transfer restrictions and the desirability of these modifications.

I. PERMITTED RESTRICTIONS

The first part of this comment deals with the scope of the restrictive provisions permitted under section 202 and the extent to which the enforcement of these restrictions modifies the common law. Subsection (c) provides for four specified restrictions which are permitted under section 202. Beyond these four, the scope of the enforceable restrictions must be determined under the broad provisions of subsection (e), which states that other "lawful" restrictions are permitted under section 202. The word "lawful" as used in this subsection might be narrowly construed to encompass only those restrictions established by Delaware statutory authority, since the Delaware Corporation Law does have other sections validating certain types of restrictions in certain instances.⁴⁹ This interpretation is not proper, however, since the word "lawful" generally refers to more than just statutory authority. "Lawful" nor-

such holders and the corporation. No restriction so imposed shall be binding with respect to securities issued prior to the adoption of the restriction unless the holders of the securities are parties to an agreement or voted in favor of the restriction.

Del. Corp. Law § 202(b).

⁴⁵ (a) . . . Unless noted conspicuously on the security, a restriction, even though permitted by this section, is ineffective except against a person with actual knowledge of the restriction.

Id. § 202(a).

⁴⁶ See C. Rohrlach, *Organizing Corporate and Other Business Enterprises* § 6.01, at 197 (rev. ed. 1953).

⁴⁷ The validity of a stock transfer restriction is determined by the law of the state in which the corporation using the restriction is incorporated. *Palmer v. Chamberlin*, 191 F.2d 532, 536-37 (5th Cir. 1951); *Restatement of Conflict of Laws* § 182, comment b at 270 (1934).

⁴⁸ Del. Corp. Law § 342(a)(2).

⁴⁹ Close corporations may use a restriction setting out permitted classes of purchasers. Del. Corp. Law § 342(b). They may also set a restriction on the total number of shareholders which can be enforced against a person whose purchase of shares increases the number of shareholders beyond the stated maximum. Del. Corp. Law § 347-(b).

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mally encompasses activities permitted under the common law as well.⁵⁰ Also, there would be no purpose in construing subsection (e) so narrowly since the other restrictions under the Delaware Corporation Law contain their own enforcement provisions.⁵¹ The more realistic interpretation of subsection (e) would be to view it as incorporating within the enforcement provisions of section 202 all those restrictions acceptable at common law under the traditional balancing test.

The most important part of the section is subsection (c) which allows, in any corporation, enforcement of the four permitted restrictions without the use of the traditional balancing test. The approach of this subsection modifies the approach of the earlier Texas and Wyoming statutes in two important aspects. First, both of the earlier statutes permitted restrictions, other than the first option, to be valid with respect to a class of shares only if there were twenty (20) or fewer shareholders in that class.⁵² The Delaware statute does not limit the application of its permitted restrictions to situations where there are a specified number of shareholders. This, it is submitted, is the better approach.

Although selective transfers are primarily the concern of small, close corporations, any attempt at a statutory definition of what constitutes a close corporation is likely to be arbitrary.⁵³ Also, under certain circumstances, courts have held restrictions reasonable and necessary in large corporations with substantial capital⁵⁴ and a large number of shareholders.⁵⁵ These large corporations would benefit by the certainty afforded smaller corporations under these statutes. Moreover, there is no substantial danger of widespread and indiscriminate use of restrictions in these corporations. Restrictions in a large enterprise create administrative burdens and difficulties in marketing the securities quickly,⁵⁶ so that the corporation, on its own, would require some substantial reason for the protection in order to contemplate undertaking these problems. Since this is the case, an arbitrary number should not determine the application of subsection (c). The better approach, adopted here by Delaware, is to make no distinction based on the number of shareholders in the class of shares restricted.⁵⁷

The second, and most important manner, in which this section modifies the earlier legislation in this area is that it allows the four permitted restric-

⁵⁰ Cf. *Sterling v. Mayflower Hotel Corp.*, 33 Del. Ch. 293, 312-13, 93 A.2d 107, 117-18 (Sup. Ct. 1952), where the Delaware Supreme Court interpreted a Delaware statute providing that the certificate of incorporation may include any management provision that is not contrary to the "laws" of Delaware as encompassing more than just the statutory "laws" of Delaware.

⁵¹ Del. Corp. Law §§ 347(d), 349.

⁵² Tex. Bus. Corp. Act art. 2.22B(2) (1956); Wyo. Stat. Ann. §§ 17-36.32(c), (d) (1965).

⁵³ 1948 New York Law Revision Comm'n Report 386.

⁵⁴ See *Martin v. Graybar Elec. Co.*, 285 F.2d 619, 621 (7th Cir. 1961) (corporation had annual sales of \$490,000,000).

⁵⁵ See *Palmer v. Chamberlin*, 191 F.2d 532, 537 (5th Cir. 1951) (one hundred and fifty-one shareholders).

⁵⁶ Painter, *supra* note 21, at 66-67.

⁵⁷ See O'Neal, *Recent Legislation Affecting Close Corporations*, 23 Law & Contemp. Prob. 341, 359 (1958).

tions in subsection (c) to be enforced without the application of the balancing test. The legislature has, in effect, carved out from the common law four exceptions to the balancing test and has declared those restrictions reasonable per se.

A. *The First-Option Restriction*

The first-option restriction, or as it is termed in the statute a "first opportunity," gives the designated optionee the right to purchase the shares at an agreed on price, or at a price to be set by a formula, before the holder can transfer the shares to a third party. At common law, in almost all jurisdictions, this restriction has been recognized as a reasonable condition on transfer,⁵⁸ provided that the characteristics of the corporation are such that there is a recognized need for the use of a stock restriction.⁵⁹

The first option is the most popular stock transfer restriction.⁶⁰ The optionee may consent to the transfer if he believes it to be in his best interest. If not, the use of the option permits the optionee directly to control the transfer of the shares between the prior holder and the new owner. As a purchaser, the optionee is able to retain the shares, or personally select among willing purchasers outside of the corporation, or sell the shares to present managers or employees in order to strengthen their interest in the company. Also, since the restriction is acceptable almost everywhere, its certainty makes it attractive.

The disadvantage of the first-option restriction is that it often requires a substantial outlay of capital to purchase the shares. An individual optionee may not be able to raise the necessary capital within the time in which the option is exercisable.⁶¹ The corporation also may not have the finances available to exercise the option.⁶² The corporation may create a reserve fund for this purpose,⁶³ but that may require the withdrawal of substantial funds from the operation of the business.

There is a second reason why the corporation may be unable to purchase the stock. The Delaware Corporation Law,⁶⁴ like many corporation statutes,⁶⁵ provides that the corporation may not purchase its shares if such purchase

⁵⁸ See F. Christy, *supra* note 20, § 39, at 5:10 n.9; O'Neal, *Restrictions on Transfer of Stock in Closely Held Corporations: Planning and Drafting*, 65 Harv. L. Rev. 773, 781 (1952).

⁵⁹ O'Neal, *supra* note 58, at 781.

⁶⁰ 2 F. O'Neal, *Close Corporations* § 7.09, at 13 (1958).

⁶¹ See *Bechtold v. Coleman Realty Co.*, 367 Pa. 208, 79 A.2d 661 (1951), in which stockholders could not raise the money necessary to exercise a purchase option on 4,000 shares that represented a controlling interest in the corporation.

⁶² For a discussion of the possible methods of financing payment of the option price and the problems associated with financing, see 2 F. O'Neal, *supra* note 60, § 7.25.

⁶³ In Delaware, a corporation is authorized by statute to create such a special reserve fund. Del. Corp. Law § 171. Since a shareholder in a close corporation frequently will not attempt to transfer except at his death, insurance on the life of the shareholder can often be used to get the necessary capital. In Delaware, insurance on the life of a stockholder, with the corporation as beneficiary, is authorized by statute. *Id.* § 122(16). See Thomas, *Ingenuity Needed in Many Buy/Sell Situations*, 16 J. Am. Soc'y C.L.U. 101 (1962).

⁶⁴ Del. Corp. Law § 160.

⁶⁵ 6A W. Fletcher, *Cyclopedia of the Law of Private Corporations* § 2848 (Perm. ed. 1950). See also ABA-ALI Model Bus. Corp. Act § 5 (1966).

will in any way impair the capital of the corporation. This means that the corporation can buy its stock only when it has surplus, and not when the aggregate value of its assets is less than the value of its outstanding capital stock.⁶⁶ It is possible that at the time the option becomes exercisable the corporation will have no surplus and, therefore, be unable to purchase the shares.

These disadvantages, which arise as a result of the necessity to purchase the stock in order to control transfer, may be used by the shareholder if he does not wish to be bound by the restriction. The shareholder may hold his shares until he believes that the optionee does not have the financial resources or cannot meet the requisite surplus requirement, and then announce his intention to sell to a third party.

Since the first-option restriction does not severely restrict the transfer of shares and has been upheld by the courts in most corporations, the adoption of the *per se* rule in this statute is not a significant change in the law. The only possible change in the law would be in regard to large corporations in which the courts have not always been willing to allow any restrictions.⁶⁷ At the same time, however, it is not likely to be used in the larger corporations, since it would require the availability, at least, of excess capital each time there is a transfer in order to maintain sufficient control, as well as creating administrative burdens and difficulties in marketing the stock. In any event, the added certainty that the *per se* rule provides justifies any harm that may result from allowing the first-option restriction in the large corporation.

Three points should be noted with regard to the manner in which the statute is drafted. First, the statute requires the option to be exercised within a reasonable time after the shareholder informs the corporation that he desires to transfer his shares. There is, however, no definition of reasonable time in this context, either in the statute or at common law.⁶⁸ This should not create any difficulties, however, since in no case has an otherwise valid restriction been invalidated because the option time was unreasonable, and options up to six months have been allowed.⁶⁹

Second, there is no requirement under the statute that the option price be reasonable. This follows the common law approach that a valid restriction is a contractual agreement and the parties should be bound to the provisions of a contract to which they have assented,⁷⁰ even though there is a wide discrepancy between market value and the option price.⁷¹ This is the better approach. The parties should be permitted to establish the terms of their agreements without judicial interference. They are still protected against fraud or bad faith in the making of the contract or in its application since the directors

⁶⁶ *In re Int'l Radiator Co.*, 10 Del. Ch. 358, 361, 92 A. 255, 256 (1914). See also Del. Corp. Law § 154.

⁶⁷ 2 F. O'Neal, *supra* note 60, § 7.06, at 10.

⁶⁸ O'Neal, *supra* note 58, at 774.

⁶⁹ See *Weiland v. Hogan*, 177 Mich. 626, 143 N.W. 599 (1913).

⁷⁰ *Arentsen v. Sherman Towel Serv. Co.*, 352 Ill. 327, 185 N.E. 822 (1933).

⁷¹ *In re Mather's Estate*, 410 Pa. 361, 189 A.2d 586 (1963) (option price of one dollar allowed for stock worth not less than one thousand and sixty dollars a share); *Allen v. Biltmore Tissue Corp.*, 2 N.Y.2d 534, 141 N.E.2d 812, 161 N.Y.S.2d 418 (1957) (option price set at the shareholders purchase price even though the stock had risen greatly in value).

and stockholders have a duty to exercise good faith in their dealings with stockholders. If a corporation were to adopt a first-option restriction in which the price was established through fraud or bad faith on the part of directors or shareholders, there would be a violation of this duty.⁷² These principles give adequate protection and, as a result, a provision requiring a reasonable price is not needed.

The third point to be noted is that options based on contingencies other than the transfer of the stock are not permitted per se under section 202. Options to purchase on the retirement of an employee are quite common and are upheld by modern courts.⁷³ They serve a legitimate corporate function by limiting the shareholders to those employed by the corporation,⁷⁴ thereby using employee ownership to create a personal interest in the business and, also, inducing valuable employees to remain with the corporation if they want to retain what may be a valuable interest.⁷⁵ At the same time, such a provision protects the corporation from disgruntled former employees.⁷⁶ This restriction may be abused, however, by directors or shareholders acting in bad faith. An employee may be dismissed so that his shares may be purchased to obtain their enhanced market value or liquidation value or to obtain their voting control.⁷⁷ Even if the shares are not redistributed for these purposes, the decrease in the number of outstanding shares will increase the value of the remaining shares.⁷⁸

An option based on a contingency other than sale was invalidated under the Delaware common law in *Greene v. E.H. Rollins & Sons, Inc.*⁷⁹ There, however, the option was exercisable for an indefinite time after termination of employment. The validity of these restrictions, nevertheless, remains in doubt in Delaware. Since the option does serve legitimate corporate purposes, a legislative declaration of its status would be of substantial benefit. The difficulties experienced in the *Greene* case could be adequately covered by a requirement similar to that in the first-option provision, that the option be exercised within a reasonable time. The abuses connected with this type of restriction could be eliminated by rigorous enforcement of the good faith requirements on the part of the courts. Thus, if the shareholder is dismissed in order to obtain his shares for their monetary or control value, the court could invalidate that particular transaction without denying validity to these restrictions in general. Certainly the question of corporate need for the restriction is separate from

⁷² *Helms v. Duckworth*, 249 F.2d 482, 487 (D.C. Cir. 1957). Although there have been no Delaware cases on this exact point, the Delaware courts have recognized the duty of directors to shareholders and shareholders to each other in analogous situations. See *Corbett v. McClintic-Marshall Corp.*, 17 Del. Ch. 165, 151 A. 218 (1930) (duty of directors to shareholders); *Bennett v. Breuil Petroleum Corp.*, 34 Del. Ch. 6, 99 A.2d 236 (1953) (duty of shareholders to each other).

⁷³ 2 F. O'Neal, *supra* note 60, § 7.09, at 14-15.

⁷⁴ *Martin v. Graybar Elec. Co.*, 285 F.2d 619, 621 (7th Cir. 1961).

⁷⁵ *Harker v. Ralston Purina Co.*, 45 F.2d 929, 930 (7th Cir. 1930). See Grossman & Herzl, *Employee Stock Options*, 1958 U. Ill. L.F. 45.

⁷⁶ *Bloomington v. Bloomington*, 107 Misc. 646, 177 N.Y.S. 873 (Sup. Ct. 1919).

⁷⁷ Note, *Exercising Options to Repurchase Employee-Held Stock: A Question of Good Faith*, 68 Yale L.J. 773 (1959).

⁷⁸ *Id.* at 774.

⁷⁹ 22 Del. Ch. 394, 2 A.2d 249 (1938).

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that of the corporation's good faith in exercising the option.⁸⁰ It is submitted that a per se rule should be adopted for options on contingencies other than the transfer of the stock. This would inject the desired certainty without denying the courts the ability to prevent abuses of the option if the corporation has acted in bad faith.

B. *The Obligation to Purchase*

The required-purchase obligation in part two of subsection (c) is the counterpart of the first option: The required-purchase obligates the corporation or some other designated individual to purchase the shares at the option of the holder. This restriction is primarily for the benefit of the individual holder. It is used in small corporations where the shares are not readily marketable, especially if they represent a minority interest.⁸¹ It is also used when employees are required to purchase stock as a condition of employment.⁸²

The disadvantages with this restriction are similar to those involved in the first-option restriction. The corporation or some other individual must be able to meet their obligation when the holder exercises his option. This may require the setting aside of substantial capital in a reserve fund. Also, the possibility that the individual or the corporation may, by reason of the capital necessary or the surplus requirement, be unable to purchase the shares undermines the protection apparently afforded by the restriction. Finally, the surplus requirement may be used as a loophole. The corporation, if it does not desire to be bound by the restriction, may balance its books in such a way as to indicate a lack of sufficient surplus.⁸³

If the restriction imposed obligates the corporation, or some individual, to purchase the shares, there should be no question of its validity. It does not, in such a case, impose a restraint on the right to alienate, but rather gives a right to the holder to require a third party to purchase the shares. The only objection to such an agreement has been that the contract is illusory since the corporation or individual might not have the funds to purchase the shares when the option is due.⁸⁴ This objection has not been followed in recent cases,⁸⁵ nor is it likely that it will be in the future.⁸⁶ Since this restriction has been accepted by the courts,⁸⁷ this part of subsection (c) serves only to clarify that acceptance.

Some difficulty is created, however, by the provision in this part of subsection (c) that the obligation to purchase is permitted on securities "which

⁸⁰ *Lewis v. H. P. Hood & Sons*, 331 Mass. 670, 675-76, 121 N.E.2d 850, 853 (1954).

⁸¹ *F. O'Neal & J. Derwin, Expulsion or Oppression of Business Associates* § 2.15, at 31 (1961).

⁸² *G. Hornstein, Corporation Law and Practice* § 195, at 258-59 (1959).

⁸³ *Id.* at 259.

⁸⁴ See *Topkin, Loring & Schwartz, Inc. v. Schwartz*, 249 N.Y. 206, 210, 163 N.E. 735, 736 (1928).

⁸⁵ *Cutter Laboratories, Inc. v. Twining*, 221 Cal. App. 2d 302, 314, 34 Cal. Rptr. 317, 324 (1963).

⁸⁶ 2 *F. O'Neal*, *supra* note 60, § 7.10, at 16.

⁸⁷ *Barron*, *supra* note 34, at 274. When conditioned on death, such agreements have been attacked on the grounds that they are testamentary and, therefore, must comply with the statutory will formalities. These attacks have failed. See *Chase Nat'l Bank v. Manufacturers Trust Co.*, 265 App. Div. 406, 410, 39 N.Y.S.2d 370, 374 (1943).

are the subject of an agreement respecting the purchase and sale of the restricted securities." There is no indication as to what type of agreement the legislature was referring to, nor as to who must be a party to the agreement. The word "agreement" is used in subsection (b) to refer to one of the possible vehicles for imposing a restriction—charter, by-laws or agreement. In this context, "agreement" means a contract among the holders, or between the holders and the corporation, to impose a given restriction. This meaning does not appear to be carried into subsection (c), since there is no apparent reason for permitting an obligation-to-purchase restriction to be imposed only by a contract among the holders or between the holders and the corporation.

Two alternative interpretations of the word "agreement" as it is used in subsection (c) may reasonably be made. First, it may refer to a different type of agreement among the holders or between the holders and the corporation. That is, it may be "an agreement respecting the purchase and sale of the restricted securities," but not an agreement imposing an obligation-to-purchase restriction. Second, it may be an agreement imposing an obligation-to-purchase restriction, but not one among the holders or between the holders and the corporation.

If the first interpretation is accepted, the problem narrows to determining exactly what type of agreement subsection (c) is referring to. The best explanation would be that it refers to the other restrictions of section 202—first-option, consent or restricted class of purchasers. The effect of the subsection would then be to require that the obligation-to-purchase be imposed only in conjunction with one of the other permitted restrictions. Although this interpretation fits the language of the statute, there does not appear to be any reason for the limitation that results. As pointed out above, the obligation-to-purchase is not a restriction on free alienability and it would ordinarily be permitted even in the absence of the statutory provisions.

The second interpretation narrows the inquiry to determining who the parties to the agreement must be. This can be answered by examining the nature of the obligation-to-purchase restriction. Although it is a "restriction" imposed on securities under subsection (c), it obligates a third party, not the holder, to purchase. Of course, the third party would have to agree to be so bound. The subsection may be restating only this obvious requirement. This interpretation is also consistent with the language of the statute, but, again, there is one difficulty. If so interpreted, the language "agreement respecting the purchase and sale of the restricted securities" is unnecessary.

Even though both interpretations have deficiencies, the second seems best. It is hard to imagine that the legislature through ambiguous language intended to impose an unnecessary additional limitation. It is more probable that it included the additional language to make clear that the "purchaser" must assent to the restriction. Clarity did not result, however, and the intended meaning can be established with certainty only through legislative amendment.

C. *Restrictions Prohibiting Classes of Transferees*

Part four of subsection (c) permits a restriction which prohibits the transfer of restricted securities to designated persons or classes of persons, if

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such designation is not "manifestly unreasonable." Under this restriction the parties can agree initially to prohibit certain transfers to insure that undesirable persons do not become shareholders. While this "veto" power is similar to that of the consent restraint, this restriction permits certain persons to be excluded ab initio, thereby reducing or eliminating conflicts which may develop later when individual transfers are considered. Any such conflicts are particularly harmful to a small, close corporation.⁸⁸ The use of set standards, to which the parties have assented, will also help to guide conduct and prevent delays and disappointments by establishing the requirements before the individual transfers are contemplated.

The disadvantages of such a restriction are obvious. It can supply only partial control since it applies only to certain transferees. Second, it is difficult to draft a restriction that is not either so broad as to restrict harmless transfers, or so narrow that it provides inadequate protection. Finally, the establishment of rigid classes does not permit consideration of exceptions for unusual cases or for changes in the corporate needs. Of course, the charter, by-laws, or contract may be amended to fit these exceptions, but, as will be seen later, this may be a difficult process.⁸⁹

For two reasons it is difficult to assess the extent to which the restriction adopted here has actually modified the common law. First, there are almost no cases treating the validity of these restrictions at common law⁹⁰ and none of the existing cases were decided in Delaware. Second, even if prohibited class restrictions were acceptable under present day common law standards, the crux of the statutory section is the meaning of the words "manifestly unreasonable," a term not found in the common law dealing with stock transfer restrictions.⁹¹ To determine if a restriction is manifestly unreasonable, the court must necessarily look to the corporation, its size, type, location, ownership distribution, and objectives—the same factors balanced at common law. The effect of the manifestly unreasonable standard, then, would be to modify, but not overrule, the common law. It provides the court with much more latitude in permitting the restriction, but it is not a per se rule as are the others enumerated in subsection (c). The scope of the increase in liberality, however,

⁸⁸ See *Moses v. Soule*, 63 Misc. 203, 209, 118 N.Y.S. 410, 414 (Sup. Ct. 1909).

⁸⁹ See pp. 427-28 *infra*.

⁹⁰ Although this restriction was before the court in one early case, the court rested its decision on the fact the restriction was placed in the by-laws and did not even discuss the validity of the restriction if it were properly imposed. *Kretzer v. Cole Bros. Lightning Rod Co.*, 193 Mo. App. 99, 181 S.W. 1066 (Ct. App. 1916). One recent case has apparently upheld such a restriction. *In re West Waterway Lumber Co.*, 59 Wash. 2d 310, 367 P.2d 807 (1962). Also, the Supreme Court of the United States has suggested that such a restriction might be valid under California law. *Eccles v. Peoples Bank*, 333 U.S. 426, 433 (1948).

⁹¹ Massachusetts, which follows the English contractual approach to stock transfer restrictions, uses a standard of "palpably unreasonable" to test the validity of all types of restrictions. *Longyear v. Hardman*, 219 Mass. 405, 408, 106 N.E. 1012, 1013 (1914). Since "palpably unreasonable" seems to be synonymous with "manifestly unreasonable," the Massachusetts stock transfer restriction cases might be of some help in interpreting this part of the Delaware statute. Any interpretational help from the Massachusetts cases, however, would have to be gained by analogizing the facts in these cases to the prohibited-class-of-purchaser restriction, since the Massachusetts courts have never considered this type of restriction.

is almost impossible to predict. Until the Delaware courts or legislature indicate the correct interpretation of this phrase, the extent of the change from the common law will remain in doubt.

One further point to be noted with regard to this section is that it only permits certain classes of purchasers to be prohibited as transferees. In a later section of the Delaware Corporation Law,⁹² dealing with special stock transfer restrictions permissible for close corporations, the legislature has permitted the use of restrictions establishing both prohibited classes of purchasers and permitted classes of purchasers. Section 202 specifically provides for the former restriction, but not the latter. The difference between the two restrictions may be only a question of semantics, of course. If exceedingly broad classes of prohibited purchasers were enumerated, only a limited number of persons would be able to purchase, a result that would normally be obtained with a restriction that permits only certain purchasers. In most circumstances, however, to allow all but certain persons to purchase is less restrictive than to allow only certain persons to purchase.⁹³

The difference between these two types of classes is important to the courts for two reasons. First, in assessing the validity of a restriction, the court should determine if the restriction is framed in terms of prohibited classes, which are allowed under section 202, or permitted classes, which are allowed only under the close corporation subchapter. Secondly, since the legislature has allowed only prohibited classes of purchasers, this is indicative of the scope of the manifestly unreasonable standard. The use of exceedingly broad classes of prohibited purchasers so that, in effect, only a limited number of persons are able to purchase is a mere change in form over a permitted class of purchasers restriction. Therefore, to uphold such a restriction would contravene the intent of the legislature. In such an instance, the restriction should be held to be within the intended scope of the manifestly unreasonable standard.

D. *The Consent Restriction*

Part three of subsection (c) permits the use of a consent restriction requiring the holder of stock to obtain the consent of the corporation or other designated individuals before he can transfer the securities. The use of this restriction allows the corporation or its shareholders to exercise control over the transfer of stock when it can not, or does not wish to, purchase the shares. By withholding consent to sales to particular purchasers, the party whose consent must be obtained can maintain almost the same control offered by a first option, but without the expenditure of capital.

There is a distinct disadvantage to the consent restriction, however. Under the first option, the shareholder is able to transfer his shares, and at a price mutually agreed on. Here, the holder is under the thumb of the consenting party, and cannot sell or transfer his shares to anyone without the approval of the consenting party.⁹⁴ This is not to say that the consenting party

⁹² Del. Corp. Law § 342(b).

⁹³ Such a distinction was recognized at common law with regard to restraints on the alienation of real property. J. Gray, *Restraints on the Alienation of Property* § 41 (1895).

⁹⁴ Courts have recognized that the consent restriction is much more restrictive than

is not held to a standard of good faith. Good faith is read into each contract, and would undoubtedly be required here, as it has been required at common law.⁹⁵ The refusal of consent would have to be for the purpose of choosing an acceptable transferee, and not arbitrarily,⁹⁶ or for personal grounds unrelated to the corporation or its business.⁹⁷ Nevertheless, bad faith may be difficult to prove, and requires litigation. Even assuming good faith, however, the peculiarities of the situation may effect a restraint on alienation for a substantial period of time until an acceptable purchaser is found.

Since the requirement of relying on another's consent can create a serious restraint, the courts at common law have been understandably reluctant to uphold this restriction.⁹⁸ Much of the present uncertainty, however, regarding the validity of this restriction is attributable to the fact that much of the authority in this area is old⁹⁹ and does not necessarily represent the more liberal attitude of modern courts. Nevertheless, the adoption of the *per se* rule for this restriction is probably the most significant change that subsection (c) makes from the common law.

Because of the disadvantages of this restriction and its uncertain validity at common law, one writer has suggested that it is unnecessary, and that a first-option restriction should be used in its place.¹⁰⁰ That restriction, however, may not always be available for control of the transfer. The ease with which the consent restriction permits control, and the fact that it does not require substantial capital from the business or the shareholders, are compelling reasons for the use of a consent restriction. On the balance, the valuable and beneficial protection offered, and the certainty in a very uncertain area, are sufficient to justify the *per se* rule adopted here; provided, however, that the requirement of good faith is vigorously applied by the courts.

Two points should be noted with regard to the manner in which this subsection is drafted. First, there is no requirement attached to the consent restriction that the consenting party act within a reasonable time. Stock which the holder desires to transfer is, in effect, unalienable during the time that the interested party is deciding whether or not to exercise an option or give his consent.¹⁰¹ For this reason a requirement was imposed in the first-option restriction that the action be taken within a reasonable time. There, however, an extended amount of time may be desired to raise the necessary capital. In

the first-option restriction. *First Nat'l Bank v. Shanks*, 34 Ohio Op. 359, 360, 73 N.E.2d 93, 94 (C.P. 1945).

⁹⁵ See *Carlson v. Ringgold County Mut. Tel. Co.*, 252 Iowa 748, 760, 108 N.W.2d 478, 485 (1961); *Dolese Bros. Co. v. Brown*, 39 Del. Ch. 1, 157 A.2d 784 (Sup. Ct. 1960). See also *Bachrach v. 1001 Tenants Corp.*, 41 Misc. 2d 512, 245 N.Y.S.2d 912 (Sup. Ct. 1963), *rev'd on other grounds*, 15 N.Y.2d 718, 205 N.E.2d 196, 256 N.Y.S.2d 929 (1965).

⁹⁶ *Carlson v. Ringgold County Mut. Tel. Co.*, 252 Iowa 748, 760-61, 108 N.W.2d 478, 485 (1961).

⁹⁷ See *Weisner v. 791 Park Ave. Corp.*, 7 App. Div. 2d 75, 180 N.Y.S.2d 734 (1958).

⁹⁸ See *Tracey v. Franklin*, 30 Del. Ch. 407, 414, 61 A.2d 780, 784 (1948), *aff'd*, 31 Del. Ch. 477, 67 A.2d 56 (Sup. Ct. 1949); *Douglas v. Aurora Daily News Co.*, 160 Ill. App. 506 (Ct. App. 1911).

⁹⁹ O'Neal, *supra* note 58, at 780.

¹⁰⁰ Comment, *Stock Transfer Restrictions and the Close Corporation—A Statutory Proposal*, 17 *Hastings L.J.* 583, 595 (1966).

¹⁰¹ *Deibel v. Kaufman*, 44 Ohio L. Abs. 321, 62 N.E.2d 770 (Ct. App. 1945).

the consent restriction, there is no financial necessity to delay the decision; yet, because there may be delays such as by a deadlock or unavailability of the consenting parties,¹⁰² some requirement of reasonable time should be included so that alienability will not be delayed for too long a period.

The second point to be noted is that no test of reasonableness is established. The section of the statute dealing with prohibited persons or classes of persons sets the standard, "manifestly unreasonable." There, however, since the classes are set in the restriction, a court can easily see the degree of restraint and evaluate the reasons for their establishing the restriction. The reasonableness of the consent restriction can be evaluated only as it is applied to individual transfers. The exercise of the restriction involves evaluation by the consenting party of the personality of the new transferee and his desire to work with present stockholders in managing the corporation. The benefit of the consent restriction is that it provides this opportunity to make a personal evaluation and, so long as this personal evaluation is exercised in good faith, no objective standard of reasonableness should be imposed by the courts. If the restriction is to be accepted at all, it should be accepted without this possibility of judicial interference.

II. SUBCHAPTER S CORPORATIONS

Subsection (d) provides that any restriction imposed to maintain Subchapter S status as an electing small business corporation is conclusively presumed to be for a reasonable purpose. At common law the court would look at such restrictions in terms of the balancing test, weighing the degree of restraint against the purpose to be served. Here the statute establishes the purpose as reasonable. The effect of this section on the balancing test is uncertain. It may be that, even assuming a reasonable purpose, the degree of restraint in some cases might be so severe that the Delaware court would find the restraint outweighed the purpose. This does not appear to be the approach followed by the court in the case of *Tracey v. Franklin*.¹⁰³ Here the restraint involved was a prohibition on the sale of stock for a period of almost ten years. The lower court stated that the restraint itself was invalid, no matter what the purpose might be.¹⁰⁴ The Supreme Court of Delaware affirmed, but noted that even this restriction must be looked at in terms of the purpose served. If a sufficiently reasonable purpose were shown, the restriction would be valid.

If the term "reasonable purpose" is construed by the courts to mean a sufficiently reasonable purpose to uphold any restriction, then all restrictions to maintain Subchapter S status would be upheld. It is doubtful that this was the effect intended by the legislature, however. The statute does not establish all restrictions used to maintain Subchapter S status as reasonable, but only that the purpose is reasonable.

The third possibility is that the court should look to the means involved to attain the reasonable purpose, as well as the purpose itself. In *Tracey v. Franklin*, the court stated that a restriction would be valid "where the circum-

¹⁰² See *In re Copal Varnish Co.*, [1917] 2 Ch. 349.

¹⁰³ 31 Del. Ch. 477, 67 A.2d 56 (Sup. Ct. 1949).

¹⁰⁴ 30 Del. Ch. 407, 414, 61 A.2d 780, 784 (1948).

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stances of a particular case convince the court that it is a reasonable means of accomplishing a purpose recognized as proper."¹⁰⁵ If this approach is followed in interpreting subsection (d), the court would allow a restriction imposed for Subchapter S purposes but only if the type of restriction used is reasonable in the light of the types of restrictions that could have been used. Since the four types of restrictions enumerated in subsection (c) are reasonable per se, the court is likely to hold that one of these types must be used if it will accomplish the desired end.

An analysis of the requirements of Subchapter S indicate that the restrictions already permitted would be sufficient to protect the corporation. The basic requirements of Subchapter S as they concern us here are: there must be ten or fewer shareholders;¹⁰⁶ all shares must be held by individuals or estates;¹⁰⁷ shareholders cannot be non-resident aliens.¹⁰⁸ Most of these qualifications could be met by the use of the restrictions permitted under section 202, principally the restrictions prohibiting certain persons or classes of persons from purchasing. Also, a corporation attempting to maintain Subchapter S status could elect to become a close corporation under the Corporation Law's special subtitle dealing with those corporations.¹⁰⁹ If the corporation chooses to accept this status, it may use the additional stock transfer restrictions permitted there. Close corporations are allowed restrictions limiting the number of shareholders,¹¹⁰ and restrictions permitting only certain persons to hold shares.¹¹¹

Since the use of these specifically permitted restrictions would adequately protect the corporation without resorting to subsection (d) of section 202, it is submitted that this subsection should be deleted from the statute. It interjects a confusing and uncertain effect on the law in this area, and may lead the Delaware courts to validate restrictions that severely limit the freedom of alienation when such restrictions are unnecessary.

III. CREATION AND ENFORCEMENT OF RESTRICTIONS

A. *Creation*

Subsection (b) of section 202 provides that restrictions may be imposed by the articles of incorporation or by-laws, or by an agreement either among the shareholders or between the shareholders and the corporation. The subsection goes on to provide that as to shares issued prior to the adoption of the restriction, the restriction shall not be binding unless the shareholders are parties to an agreement or voted in favor of the restriction.

At common law, courts generally recognized the right to impose restrictions by contract or the articles of incorporation, but the courts split on whether restrictions can be imposed in the by-laws.¹¹² Some courts felt that

¹⁰⁵ 31 Del. Ch. at 484, 67 A.2d at 59.

¹⁰⁶ Int. Rev. Code of 1954, § 1371(a)(1).

¹⁰⁷ Id. § 1371(a)(2).

¹⁰⁸ Id. § 1371(a)(3).

¹⁰⁹ Del. Corp. Law § 342(a)(1) (thirty shareholders).

¹¹⁰ Id. § 347(b).

¹¹¹ Id. § 342(b).

¹¹² Cataldo, Stock Transfer Restrictions and the Closed Corporation, 37 Va. L. Rev. 229, 235-36 (1951).

by-laws concerned the general management of the corporation¹¹³ or the formalities of transfer,¹¹⁴ and could not be used to impose restrictions unless there was specific statutory authority.¹¹⁵ Courts now uphold by-laws imposing restrictions either by finding the necessary statutory authority,¹¹⁶ or by finding that the by-law is an enforceable contract among the parties voting for it.¹¹⁷ The effect of this latter approach is to enforce restrictions in the by-laws only against those who have assented thereto. As to shares issued prior to imposition of the restriction, the same result is required by subsection 202(b) of the Delaware Corporation Law.

The statute adopts the better approach in allowing restrictions to be placed in the by-laws as well as in the articles of incorporation. The only practical effect is in the vote required to carry the restriction. As to unissued shares, the stockholders should be free to set the percentage of outstanding shares required to impose a restriction at any number they desire. Imposition of restrictions on issued shares presents a different problem because it may deprive existing shareholders of their ability to alienate stock even though they do not vote for the restriction. This problem is taken care of by the latter part of subsection (b) which requires assent to restrictions on issued shares and should not influence the determination of whether to allow restrictions in the by-laws.

The approach of the statute to the imposition of restrictions on issued shares is also reasonable. There is good reason to require the consent of the outstanding shareholders to the imposition of the restrictions on issued shares.¹¹⁸ These restrictions may involve serious limitations on the free alienation of the stock, or serious financial obligations on the corporation or the shareholders.

An inequitable situation may result, however, if the requirement that holders of outstanding shares assent to a restriction on issued shares is applied to restrictions imposed before the effective date of this statute.¹¹⁹ Those

¹¹³ *Id.* at 236; see *Searles v. Bar Harbor Banking & Trust Co.*, 128 Me. 34, 38-39, 145 A. 391, 393 (1929).

¹¹⁴ See *Kretzer v. Cole Bros. Lightning Rod Co.*, 193 Mo. App. 99, 103-04, 181 S.W. 1066, 1067 (Ct. App. 1916); *Morris v. Hussong Dyeing Mach. Co.*, 81 N.J. Eq. 256, 260, 86 A. 1026, 1028 (1913).

¹¹⁵ *Nicholson v. Franklin Brewing Co.*, 82 Ohio St. 94, 110, 91 N.E. 991, 994 (1910).

¹¹⁶ See Conn. Gen. Stat. Ann. § 33-306a (Supp. 1966); Fla. Stat. Ann. § 608.0105-(1)(d) (Supp. 1966); Iowa Code Ann. § 496A.26 (1962).

¹¹⁷ See *First Nat'l Bank v. Shanks*, 34 Ohio Op. 359, 362, 73 N.E.2d 93, 97 (C.P. 1945); *Searles v. Bar Harbor Banking & Trust Co.*, 128 Me. 34, 39, 145 A. 391, 393 (1929).

¹¹⁸ *Painter, Stock Transfer Restrictions: Continuing Uncertainties and a Legislative Proposal*, 6 Vill. L. Rev. 48, 65 (1960). But see *Tu-Vu Drive-In Corp. v. Ashkins*, 61 Cal. 2d 283, 391 P.2d 828, 38 Cal. Rptr. 348 (1964).

¹¹⁹ In Delaware this provision probably would not be applied to restrictions enacted before the effective date of this statute since to do so would make the statute retroactive and "retroactive operation will not be inferred." *Bowling v. Delaware Rayon Co.*, 38 Del. 111, 114, 188 A. 769, 770 (Super. Ct. 1937). Therefore, in Delaware the common law may govern voting requirements for restrictions imposed before the effective date of the statute. There are, however, no cases in Delaware treating voting requirements for the imposition of restrictions on issued shares. In other jurisdictions, the courts have taken divergent views on these voting requirements. Compare *Sandor Petroleum Corp. v. Williams*, 321 S.W.2d 614 (Tex. Civ. App. 1959), with *Tu-Vu Drive-*

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who voted for the restriction on the assumption that all shares would be bound now hold restricted securities. But those dissenting to this restriction would, under this statute, be free to alienate their shares. As a result, up to one half of the securities may not be restricted. Since only some of the shareholders may be bound, there may no longer be a substantial corporate purpose served by the restriction. Competitors can now buy to look at corporate books and records. Any scheme of employee ownership might now be destroyed, and the harmony of the close corporation impaired. Yet, because the statute, in adopting a *per se* rule, does not require a substantial purpose, unless the shareholders vote to remove the restriction, the shares will remain bound. Such a vote to remove the restriction may, as shall be seen later, require the unanimous consent of all shareholders, and the shareholders with unrestricted securities are not likely to vote for removal. A provision should be included in the statute to remedy this situation by allowing the holders of restricted securities to reconsider their vote for restrictions on issued shares if the restrictions were adopted prior to the enactment of the statute.

One further difficulty arises with regard to the requirement of consent by the holder of stock issued prior to the adoption of the restriction. The statute requires that the "holder" be a party to an agreement or have voted in favor of the restriction before the securities will be bound. Under the literal meaning of this subsection, even if a prior shareholder did vote for a restriction, his transferee, the present "holder," is not bound since he did not vote for the restriction nor was he a party to a contract in which he agreed to be bound.

It is not likely, however, that the legislature intended to bind only the immediate assenting parties and not transferees who have notice of the restriction. This particular part of subsection (b) refers to restrictions which "shall be binding with respect to securities." It does not refer to the subsequent enforcement of the restrictions. This part, therefore, is aimed at the initial application of the restriction to the securities, requiring the holder to assent to the imposition of a restriction in order to bind these shares. Once the restriction has attached to the securities by reason of the holder's consent, it could be enforced against a subsequent holder of the securities so bound under the provisions of subsection (a).

B. Enforcement

Subsection (a) of section 202 contains the enforcement provision. The subsection provides that before the restriction may be enforced it must be noted conspicuously on the security, or the shareholder must have actual knowledge of it. This follows the approach of the Uniform Commercial Code [hereinafter referred to as the Code], enacted in Delaware, in three aspects. First, both statutes require only that the restriction be noted, not set out in full.¹²⁰ This has long been the law in Delaware under the Uniform Stock

In *Corp. v. Ashkins*, 61 Cal. 2d 283, 391 P.2d 828, 38 Cal. Rptr. 348 (1964). The best approach in Delaware may be for the court to use the statute as a statement of public policy in this area and follow it in requiring that the holder agree to any restriction on the transfer of issued stock.

¹²⁰ See Uniform Commercial Code §§ 8-204, -301.

Transfer Act.¹²¹ Second, both the Code and the Corporation Law allow enforcement of the restriction, even if it is not noted, as long as there is actual knowledge of its presence.¹²² This is a change from the Uniform Stock Transfer Act which did not provide for enforcement against one with knowledge if the restriction was not noted on the stock.¹²³ Third, section 202 requires the notation of all restrictions. Section 8-204 of the Code requires that restrictions on transfer be noted only if they were imposed by the corporation. Section 8-301(2), however, protects a bona fide purchaser of stock against adverse claims which include transfer restrictions. Therefore, under the Code, notation is required not only as to issuer's restrictions but also as to restrictions otherwise imposed in order to protect the parties from a purchaser without knowledge.

Subsection (a) further provides that restrictions permitted under section 202, and noted on the securities may be enforced against the holder, or any transferee or successor of the holder, including an executor, administrator, trustee, guardian or other fiduciary entrusted with like responsibility for the holder or his estate. In measuring the effect of this statute upon the common law, two points must be considered. First, the statute provides for enforcement of permitted restrictions against certain parties. It does not stipulate what remedies will be given after the right to enforce is established. Presumably, the remedy to be given is to be determined by the courts under common law principles. At common law, an equitable remedy can be obtained, providing that the option price is not unconscionable to the extent it is indicative of fraud¹²⁴ or the terms of the restriction are not too indefinite to be enforced.¹²⁵ Any legal remedy would, in most instances, be inadequate since the purpose of the restriction is to insure that only certain persons hold the stock. The harm to the corporation or other shareholders if the stock were to go to a competitor or investor could never be assessed in terms of a dollar value.¹²⁶ Thus at common law, the courts have permitted refusals to transfer on the books of the corporation,¹²⁷ injunctions against sales,¹²⁸ or to rescind sales,¹²⁹ or actions for declaratory relief,¹³⁰ or for immediate enforcement of restrictions,

¹²¹ *Allen v. Biltmore Tissue Corp.*, 2 N.Y.2d 534, 539-40, 141 N.E.2d 812, 814-15, 161 N.Y.S.2d 418, 420-21 (1957); Uniform Stock Transfer Act § 15.

¹²² See Uniform Commercial Code §§ 8-204, -301.

¹²³ Uniform Stock Transfer Act § 15. There was disagreement in the courts as to the effect of the failure of the Uniform Stock Transfer Act to provide for purchasers with actual notice. Some courts held that the purchaser with actual notice was not bound unless the presence of the restriction was noted on the shares. See *Hopwood v. Topsham Tel. Co.*, 120 Vt. 97, 132 A.2d 170 (1957). Other courts held that the purchaser with actual notice was bound. See *Tomoser v. Kamphausen*, 307 N.Y. 797, 121 N.E.2d 622 (1954).

¹²⁴ *Palmer v. Chamberlin*, 191 F.2d 532, 541 (5th Cir. 1951). Cf. Uniform Commercial Code § 2-302.

¹²⁵ *Hardin v. Rosenthal*, 213 Ga. 319, 98 S.E.2d 901 (1957).

¹²⁶ See *Bohnsack v. Detroit Trust Co.*, 292 Mich. 167, 173, 290 N.W. 367, 369 (1940).

¹²⁷ See *Mason v. Mallard Tel. Co.*, 213 Iowa 1076, 240 N.W. 671 (1932).

¹²⁸ See *Doss v. Yingling*, 95 Ind. App. 494, 172 N.E. 801 (App. Ct. 1930).

¹²⁹ See *Tomoser v. Kamphausen*, 307 N.Y. 797, 121 N.E.2d 622 (1954).

¹³⁰ See *Searles v. Bar Harbor Banking & Trust Co.*, 128 Me. 34, 145 A. 391 (1929).

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such as an option, against the new holder.¹³¹ Since the relief needed will depend on the manner and extent that the parties have acted and the restriction involved in each case, the general provision for enforcement adopted here is preferable.

Second, the statute provides that restrictions may be enforced against only the holder or his successor or transferee. It does not provide for enforcement against prior holders¹³² or the corporation. The reason for the restrictive application of the enforcement section is clear. In suits against prior holders or the corporation the remedy sought would be damages, not enforcement in the sense of an equitable remedy. Thus a suit against a prior holder for transferring his securities in breach of the restriction would not be for specific enforcement of the restriction since the prior holder no longer has possession of the shares. An equitable remedy could be obtained only in a suit against the holder. Similarly, if the corporation or other individual is obligated to purchase the shares and refuses to do so the holder would have an adequate remedy at law—recovery of the difference between the sale price set by the restriction and the market value of the shares.¹³³ The intent of the legislature, therefore, was to specify the persons who, in equity, will have a duty to restore the shares to those whom the restrictions protect. Beyond this the legislature is silent. The silence as to enforcement rights where a legal remedy is sought should not be taken to mean that there is no legal right to enforce. The legislature has not concerned itself with these situations but, instead, left the whole question of rights and remedies at law to the courts.

This approach creates serious problems, however. The statute does not say that the four types of restrictions enumerated in subsection (c) are lawful, nor does it say that restrictions lawful at common law are lawful under section 202. Instead the statute states that all these restrictions are "permitted by this section," and in subsection (a) that restrictions permitted by this section may be enforced against certain persons. Since no enforcement rights are provided where legal remedies are sought, there is no indication whether per se rules or the balancing test should be used to determine the validity of a restriction in a suit for damages. This deficiency is particularly acute in relation to the obligation to purchase restriction. That restriction is permitted under section 202, but, since enforcement would not be sought against a person enumerated in subsection (a), there is no remedy for the per se rule adopted.

It is not likely that the legislature intended to create a per se rule with regard to a type of restriction and then go on to make it inapplicable by providing no right of enforcement. The legislative intent was probably to make the restrictions permitted under subsection (c) "lawful." That is, the words "permitted by this section" were intended to mean "lawful," even

¹³¹ See *Palmer v. Chamberlin*, 191 F.2d 532 (5th Cir. 1951).

¹³² The statute should be read to use the Code definition of holder. Under this definition, a holder is the person to whom the stock is endorsed and who has possession of the stock. Uniform Commercial Code § 1-201(20). Since the prior holder has transferred the stock and no longer has possession, he does not fit this definition.

¹³³ See *Reiman v. Northern Zaleski Ltd.*, 207 Misc. 351, 138 N.Y.S.2d 627 (Sup. Ct. 1955).

though they appear to mean something less. Yet it is still difficult to understand why the legislature adopted the unusual phrasing of section 202, when it was easy for them to state that the subsection (c) and (e) restrictions are lawful.

The final question arising under the enforcement section involves the persons against whom the restrictions may be enforced. The basic provision of the statute is to allow enforcement against the holder. Section 201 of the Delaware Corporation Law states that, unless otherwise provided, the Uniform Commercial Code, Article 8 shall regulate stock transfers. The Code defines holder as one who is in possession of a security specifically indorsed to him or to his order, or that is indorsed to bearer or in blank.¹³⁴ In addition to the holder, section 202 provides enforcement against a transferee or successor of the holder, including, among others, administrators, executors, guardians and trustees. Although the enumeration of certain transferees and successors may add some clarity, the meaning of the term transferee is not free from ambiguity. Clearly, a transferee is one who receives the stock through a transfer, but the word transfer is not specifically defined, either in this section, or in the Code. Since most transfers involve indorsement to the transferee and transfer of possession, making the transferee a holder subject to the enforcement provisions, there is no problem in most cases. There is one common transaction, however, in which the interest created may not be that of a holder. This is the creation of a security interest in the shares. To determine whether the secured party is bound by the restriction, therefore, the question of whether the creation of a security interest is a transfer must be answered.

Although the Code does not define transfer, it does, in section 9-311, specifically use the word in conjunction with the creation of a security interest. Similarly, Section 159 of the Delaware Corporation Law refers to a transfer made for collateral security and not absolutely. It is submitted, therefore, that the word transfer as used in section 202 includes the creation of a security interest, so that if there is a restriction, its terms must be complied with before a valid security interest can be created.¹³⁵ This result is an extension of the common law, which generally did not require compliance with restrictions until there was a transfer, or attempted transfer, of title and possession in satisfaction of the underlying debt.¹³⁶ The extended provision of section 202 would seem to be beneficial, since the debtor may assign his voting rights on the books of the corporation to the secured party and the secured party only is thereafter empowered to vote the stock.¹³⁷

The enforcement provisions, although limited in scope to situations where equitable remedies would be given, permits enforcement against sufficient individuals so that realistic protection is available to the corporation

¹³⁴ Uniform Commercial Code § 1-201(20).

¹³⁵ See Note, Restrictions on Stock Transfer, 63 Dick. L. Rev. 265, 268-69 (1950).

¹³⁶ *Weissman v. Lincoln Corp.*, 76 So. 2d 478, 482-83 (Fla. 1954); *Good Fellows Assoc. v. Silverman*, 283 Mass. 173, 181, 186 N.E. 48, 50 (1933). Under the Uniform Stock Transfer Act such a result would seem mandatory since transfer is defined only as transfer of legal title. Uniform Stock Transfer Act § 22(1).

¹³⁷ Under the Code, a pledge is the only permissible method of perfecting a security interest in securities. Uniform Commercial Code § 9-304(1). Del. Corp. Law § 217(a) specifically allows assignment of voting rights to a pledgee.

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and its shareholders. In addition, they leave the courts free to fashion the remedy to the particular facts in each case without the burden of inflexible and often inappropriate rules. The only major difficulty with the provision is the conflict between the permitted restrictions of subsection (c) and the enforcement section when legal remedies are sought. The uncertainty of the test to be applied in determining legal remedies and the validity of the obligation to purchase restriction could have been avoided by providing that the restrictions of subsection (c) were "lawful" rather than "permitted by this section."

IV. REPEAL AND AMENDMENT OF RESTRICTIONS

Section 202 provides for the imposition and enforcement of stock transfer restrictions, but does not provide for repeal and amendment. Presumably, then, repeal and amendment of restrictions is governed by section 242 which provides that the articles of incorporation may be amended by a two-thirds vote of the shares, or by section 109 which provides that the by-laws may be amended or repealed by the shareholders or, if given the power in the articles of incorporation, by the board of directors. Most courts faced with the question of whether the normal requirements of amendment and repeal are applicable to stock transfer restrictions have held, however, that since restrictions create personal rights they cannot be treated as ordinary by-law or article of incorporation provisions.¹³⁸ These courts require the unanimous consent of all interested parties to amend or repeal restrictive provisions.¹³⁹

It is submitted that in Delaware this approach is not correct at least to the question of repeal. First, the basic arguments for such a rule are no longer accepted. The theory that shareholders have immutable personal or vested rights accompanying the shares has been discarded by the courts.¹⁴⁰ Nor is the fact that stockholders may have relied on the protection of the restriction a valid reason for adopting a unanimity requirement since that reliance must be qualified by the knowledge that the corporation law provides for amendment or repeal of the by-laws or articles of incorporation by less than unanimous consent.¹⁴¹ Second, this approach is not consistent with the Delaware statutory scheme. Nowhere in the statute is there a mandate to adopt special requirements with respect to the repeal of stock transfer restrictions. The weight of the absence of a provision is strengthened by the fact that when the legislature did not wish to follow the statutory voting standards when dealing with the imposition of restrictions on issued shares, it specifically provided for unanimous vote of the outstanding shares.¹⁴²

¹³⁸ See *Bechtold v. Coleman Realty Co.*, 367 Pa. 208, 79 A.2d 661 (1951); *Loch v. Paola Farmers Union*, 130 Kan. 522, 287 P. 269 (1930); *Johnson v. Tribune-Herald Co.*, 155 Ga. 204, 166 S.E. 810 (1923). Contra, *Silva v. Coastal Plywood & Timber Co.*, 124 Cal. App. 2d 276, 268 P.2d 510 (Ct. App. 1954).

¹³⁹ Cases cited note 138 supra.

¹⁴⁰ Cf. *Gibson, How Fixed Are Class Shareholder Rights?* 23 *Law & Contemp. Prob.* 283, 291-92 (1958); see 14 *Sw. L.J.* 106, 108 (1960).

¹⁴¹ Cf. *Federal United Corp. v. Havender*, 24 Del. Ch. 318, 333-34, 11 A.2d 331, 338 (Sup. Ct. 1940); *In re Int'l Radiator Co.*, 10 Del. Ch. 358, 360, 92 A. 255, 256 (1914).

¹⁴² Del. Corp. Law § 202(b).

Finally, it should be kept in mind that repeal promotes free alienability of shares. To require unanimous consent would be to allow one shareholder to block an attempt at free alienability when, in all likelihood, there is no longer a valid corporate purpose to be served. It is submitted, therefore, that repeal should be permitted by meeting only the general voting requirements of the Corporation Law.

Amendment, however, presents a different problem. When a stock transfer restriction is amended, not repealed, there is still a restriction on the securities. Moreover, it is a restriction in a different form than the one originally assented to by the shareholders. When the price of a first option is altered or changes are made in the persons or classes of persons prohibited from purchasing the shares, there is, in effect, a new restriction being imposed. It is submitted that amendments, which require the imposition of a changed restriction, fall within the statutory requirement of subsection (b) that any restriction imposed on issued shares requires the unanimous consent of the outstanding shares.

V. CONCLUSION

The new approach taken by the Delaware Legislature to the problems created by the use of stock transfer restrictions is, on the whole, an improvement over past legislation in this area. The most significant change made by the statute is the establishment of certain restrictions as valid *per se*. The stability acquired by establishing *per se* rules in this area more than offsets any undesirable increase in restraints on alienation. It is doubtful, however, that any benefit that may be derived from the Subchapter S provision is sufficient to offset the problems created by its inclusion. At the same time, some provisions should be added to the section, specifically provisions dealing with permissible legal remedies, repeal, amendment, options to purchase at times other than at the time of an attempted transfer, and a provision for reevaluation of restrictions adopted prior to the enactment of this statute by less than unanimous consent of the outstanding shareholders. Also, the language used in the statute raises some interpretation problems, especially the use of the phrase "permitted by this section." Nevertheless, the section adopted here presents a substantial improvement over the common law and prior legislation in this area, and its approach should be considered by other states in the future.

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